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Summary of the Economic and Social Survey of Asia and the Pacific 2008

Summary

According to the *Economic and Social Survey of Asia and the Pacific 2008*, developing economies in the Asia-Pacific region, having enjoyed their fastest growth in a decade, are expected to see it moderate to 7.7 per cent in 2008, a slight reduction from the growth rate of 8.2 per cent in 2007. The main short-term challenge to economic prospects comes from the still unravelling sub-prime credit crisis in the United States of America and its impact on the world economy. The survey emphasizes that the region's solid macroeconomic fundamentals, painstakingly put in place and strengthened through the years, have prepared the countries of Asia and the Pacific to absorb and adapt to such external shocks.

Despite good economic performance and the efforts of Governments to foster inclusive development, there are, however, a number of emerging problems in the region. Over 600 million of the world's poor still live in Asia, nearly two thirds of the global total, mainly in rural areas. Other statistics are equally staggering. As many as 97 million children remain underweight, and 4 million children die before reaching age 5. While the region is well prepared to ride out the current turbulence in the global economy, smaller economic shocks can severely affect those most vulnerable in the population. The long-term impact of those shocks, specifically in terms of poverty, unemployment and inequality, is of great concern, and raises a renewed call for the sharing of prosperity and the fruits of high growth and for the placement of sound socio-economic policies at the top of the region's agenda.

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In that spirit, the 2008 survey takes a closer look at agriculture, which is seen as a critical determining factor in poverty reduction and rural development activities. The agricultural sector, which still provides jobs for 60 per cent of the working population in the Asia and Pacific region, sheltering the majority of the poor, has been neglected, and its capacity to lower poverty and reduce inequality has been undermined. Long-term development issues confronting agriculture need to be addressed head on. The survey argues that increasing agricultural productivity in the region can have a profound impact on reducing poverty and proposes a two-track strategy to ensure that agriculture is both economically and socially viable.

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I. Introduction

1. The *Economic and Social Survey of Asia and the Pacific 2008* examines the region's key short- and medium-term prospects and challenges in macroeconomic and selected social areas, especially from the point of view of minimizing human suffering, whether as a result of economic hardship or social instability. The survey also explores critical long-term development issues relevant to all developing countries in the region. In that context, the 2008 survey takes a closer look at agriculture, seen as a critical determinant in poverty reduction and rural development efforts. The publication emphasizes the need to address directly the neglect of agriculture, which still provides jobs for 60 per cent of the working population in the Asia and Pacific region and shelters the majority of the poor, and demonstrates that by increasing agricultural productivity the region can make a significant dent in poverty. The survey proposes a two-track strategy to ensure that agriculture is economically and socially viable and to facilitate migration from the agricultural sector by providing the poor with other skills.

II. Growth to moderate in 2008 but remain robust

2. Developing economies in the Asia-Pacific region, having enjoyed their fastest growth in a decade, are expected to see it moderate to 7.7 per cent in 2008, down slightly from 8.2 per cent in 2007 (see table, and figure I). Developed economies in the region are expected to grow by 1.6 per cent in 2008, slipping from 2 per cent in 2007. The decline in performance is the result of the economic slowdown in the United States of America driven by the end of the housing bubble, the unfolding credit crunch besetting the United States and Europe and the appreciation of many Asia and Pacific currencies against the United States dollar. The economies of China and India, the engines of regional growth, are expected to expand at a brisk pace in 2008, boosting the rest of the region. Commodity- and energy-exporting countries, in particular the Russian Federation, are expected to contribute to the region's strength.

3. Exports may suffer from slower growth in the industrialized countries, but strong domestic demand, driven by consumption in fast-growing countries and by fiscal accommodation, should cushion the blow. In export-dependent economies in East and South-East Asia, exports will have a reduced effect on overall growth, but businesses in China will continue to offer economic opportunities. There will also be an increase in domestic demand, both in consumption and investment.

4. North and Central Asia will continue to benefit from a growth in consumption and construction, thanks to high energy prices. Countries in South and South-West Asia, with domestic economies that are traditionally demand driven, will continue to benefit from strong private consumption and investment and from expansionary fiscal policy. Fiji and Tonga are expected to recover from economic contractions in 2007, the result of political unrest, while in Papua New Guinea there will be a rise in consumption as the benefits of high commodity prices spill over to the rest of the economy.

Table
Selected economies of the Economic and Social Commission for Asia and the Pacific region: rates of economic growth and inflation, 2006-2008
(Percentage)

	Real gross domestic product			*Inflation*[a]		
	2006	*2007*[b]	*2008*[c]	*2006*	*2007*[b]	*2008*[c]
Developing economies of the ESCAP region[d]	8.1	8.2	7.7	4.4	5.1	4.6
East and North-East Asia	8.7	9.0	8.4	1.6	3.8	3.3
China	11.1	11.4	10.7	1.5	4.8	3.5
Hong Kong, China	6.8	6.1	5.7	2.0	1.8	3.4
Mongolia	8.4	9.0	8.0	5.1	9.0	..
Republic of Korea	5.0	5.0	4.9	2.2	2.6	3.1
Taiwan Province of China	4.7	5.5	4.7	0.6	1.8	2.4
North and Central Asia	7.6	8.6	7.1	9.7	9.4	8.2
Armenia	13.3	13.8	9.0	2.9	4.4	4.0
Azerbaijan	34.5	25.0	25.0	8.3	16.7	16.0
Georgia	9.4	11.0	9.0	9.2	9.2	8.0
Kazakhstan	10.6	9.0	9.0	8.6	10.8	8.0
Kyrgyzstan	2.7	8.2	7.0	5.6	10.2	5.0
Russian Federation	6.7	8.1	6.5	9.7	9.0	8.0
Tajikistan	7.0	7.8	6.5	11.9	21.5	10.0
Turkmenistan	9.0	10.0	10.0	8.2	6.5	9.0
Uzbekistan	7.3	9.0	7.0	14.2	12.2	9.8
Pacific island economies	3.1	2.7	4.8	2.8	2.8	3.1
Cook Islands	0.8	2.5	3.5	3.4	2.8	2.0
Fiji	3.6	-3.9	2.2	2.5	4.1	3.0
Papua New Guinea	2.6	6.2	6.6	2.3	1.8	2.9
Samoa	1.8	3.0	3.5	3.3	4.4	4.1
Solomon Islands	6.1	5.4	4.2	8.1	6.3	7.3
Tonga	1.3	-3.5	0.8	7.0	5.9	5.0
Vanuatu	5.5	4.7	4.6	2.6	2.5	2.5
South and South-West Asia[e]	8.0	7.4	7.4	8.3	7.9	7.0
Bangladesh	6.7	6.5	6.5	7.2	7.2	6.5
India	9.6	9.0	9.0	6.7	5.5	5.0
Iran (Islamic Republic of)	6.2	5.8	5.0	13.6	17.0	16.0
Nepal	2.8	2.5	4.0	8.0	6.4	6.0
Pakistan	6.6	7.0	6.5	7.9	7.8	7.5
Sri Lanka	7.7	6.7	7.0	10.0	15.8	10.0
Turkey	6.1	5.0	5.5	9.6	8.6	6.8

	Real gross domestic product			*Inflation*[a]		
	2006	*2007*[b]	*2008*[c]	*2006*	*2007*[b]	*2008*[c]
South-East Asia	6.0	6.2	5.8	6.7	3.7	4.4
Cambodia	10.8	8.5	7.0	4.7	3.0	3.0
Indonesia	5.5	6.2	6.2	13.1	6.3	6.4
Lao People's Democratic Republic	8.3	7.4	8.1	6.8	4.0	5.0
Malaysia	5.9	5.7	5.8	3.6	2.0	2.8
Philippines	5.4	7.0	6.7	6.2	2.7	3.5
Singapore	7.9	7.5	4.9	1.0	1.8	3.0
Thailand	5.1	4.5	4.9	4.7	2.3	3.3
Viet Nam	8.2	8.4	8.2	7.7	7.9	7.7
Developed economies of the ESCAP region	2.4	2.0	1.6	0.6	0.2	0.6
Australia	2.7	4.2	3.2	3.5	2.4	3.1
Japan	2.4	1.8	1.4	0.3	0.0	0.4
New Zealand	1.8	3.1	2.3	3.4	2.4	2.6

Sources: Economic and Social Commission for Asia and the Pacific (ESCAP), based on national sources; International Monetary Fund (IMF), *International Financial Statistics*, CD-ROM (Washington, D.C., 2007); Asian Development Bank (ADB), *Key Indicators of Developing Asian and Pacific Countries 2007* (Manila, 2007); Inter-State Statistical Committee of the Commonwealth of Independent States, available from http://www.cisstat.com (accessed 3 December 2007 and 5 February 2008); and ESCAP estimates.

[a] Changes in the consumer price index.

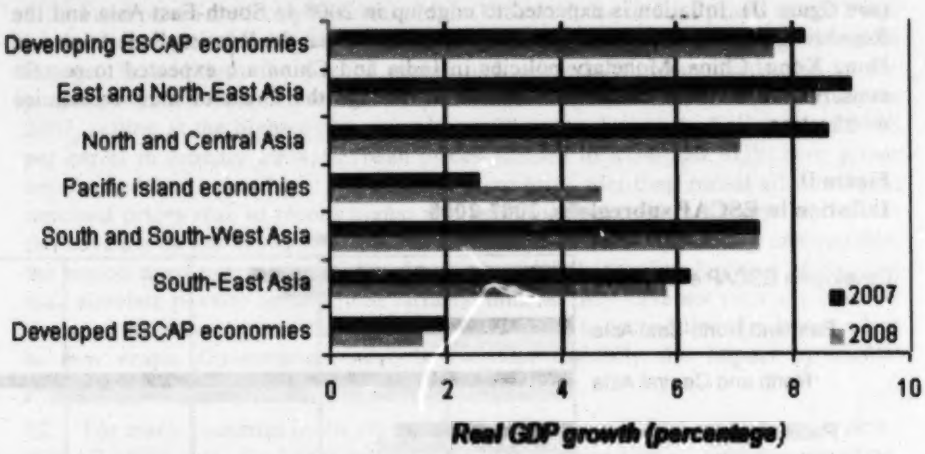
[b] Estimate.

[c] Forecast.

[d] Based on data for 38 (developing) economies representing more than 95 per cent of the population of the region (including the Central Asian republics); gross domestic product (GDP) figures at market prices in United States dollars in 2004 (at 2000 prices) have been used as weights to calculate the regional and subregional growth rates.

[e] Fiscal year 2005/06 is 2005 for India and the Islamic Republic of Iran and 2006 for Bangladesh, Nepal and Pakistan.

Figure I
Rates of economic growth in the ESCAP region, 2007-2008



Sources: ESCAP, based on national sources; IMF, *International Financial Statistics*, CD-ROM (Washington, D.C., 2007); ADB, *Key Indicators of Developing Asian and Pacific Countries 2007* (Manila, 2007); Inter-State Statistical Committee of the Commonwealth of Independent States, available from http://www.cisstat.com (accessed 3 December 2007 and 5 February 2008); and ESCAP estimates.

Note: Figures for 2007 are estimates and those for 2008 are forecasts. There are 38 developing ESCAP economies. Calculations are based on the weighted average of GDP figures at market prices in United States dollars in 2004 (at 2000 prices).

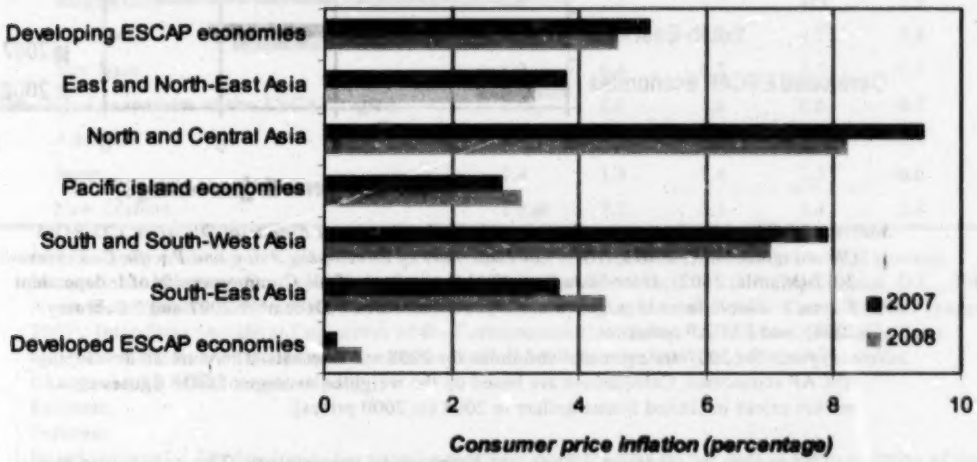
5. The region is entering a phase of heightened uncertainty. The sub-prime credit crisis in the United States is still unravelling, and a significant slowdown of that economy and further turmoil in financial markets cannot be ruled out. In 2007 the Asia-Pacific economies felt the effects of the global financial turmoil, largely through increased volatility in domestic equity markets and a measurable widening of the yield on their external debts, although neither effect was long-lasting. The resilience of the region lies mainly in its healthy macroeconomic base, which has enabled countries to adopt supportive fiscal and monetary policies despite a significant decline in export growth, financial market volatility and inflationary pressures as a result of high oil prices. Large foreign reserves have added to that resilience.

A. Greater uncertainty about inflation

6. Inflation in the developing economies of the ESCAP region was 5.1 per cent in 2007, up from 4.4 per cent in 2006. Currency appreciation in most economies moderated the impact of high international oil and food prices. With the exception of East and North-East Asia, all ESCAP subregions had lower inflation in 2007 than in 2006, and monetary policy has varied accordingly. China, India, the Republic of Korea and Taiwan Province of China tightened their monetary stance in 2007, while Malaysia maintained steady interest rates. In contrast, Indonesia, the Philippines and Thailand eased their interest rates.

7. Inflation for the developing economies of Asia and the Pacific is projected at 4.6 per cent in 2008, with currency appreciation cushioning high oil and food prices (see figure II). Inflation is expected to edge up in 2008 in South-East Asia and the Republic of Korea, but should moderate in China, India, the Russian Federation and Hong Kong, China. Monetary policies in India and China are expected to remain conservative as those countries continue to manage the threat of their economies overheating.

Figure II
Inflation in ESCAP subregions, 2007-2008



Source: ESCAP calculations.

Note: Figures for 2007 are estimates and those for 2008 are forecasts. Inflation rates refer to changes in the consumer price index. There are 38 developing ESCAP economies. Calculations are based on the weighted average of GDP figures at market prices in United States dollars in 2004 (2000 prices).

8. Monetary authorities face a dilemma in 2008. Restrictive policies may be required to counter inflationary pressures, but permissive policies may also be needed in order to manage significant slowdowns in the growth of GDP. Countries with credible monetary policies and lower inflationary expectations should be able to ride out inflation in 2008.

9. The key challenge is to decipher how much of the surge in oil and food prices in 2007 might continue in 2008 and beyond. The price of Brent crude oil hovered at $70 a barrel for most of 2007, approaching $100 in November, and reaching that price in January 2008. A weakening United States dollar and geopolitical tensions close to major oil-producing areas have been, and will continue to be, factors outweighing those of demand in determining price movements.

10. Pressure on oil prices may ease as the industrial economies, led by the United States, slow down. Recent increases in the price of oil also reflect speculation. There is reason to believe that supplies may grow, especially as new fossil fuels become viable, investments in remote areas and deeper waters pay off and oil sands, heavy crude and coal-to-oil conversions are developed.

B. Food inflation: the next big challenge

11. Food prices are likely to remain high. The rapid rise in food prices in 2007 was partly the result of drought in Australia, flooding in China and dry weather in Europe. In addition, the use of grains and oilseeds, the key feedstuffs in the production of biofuels, led to a marked increase in agricultural commodity prices in 2007, selling at the highest prices in almost 30 years. The cost of oil reached $100 per barrel in January 2008; soybean prices jumped to a 34-year high; corn prices approached an 11-year high; wheat prices were just under their recent all-time high; rapeseed prices rose to record highs; and palm oil futures hit a historic high. With the advance of the movement towards the use of biofuels apparently unstoppable, the region must prepare for higher food prices. While the development of biofuels may alleviate poverty among rural farmers, thus far they have not seen any benefits since, at the present time, they lack the wherewithal to extend their lands and adapt to new crops. Governments need to consider carefully the impact of biofuel production on the poor.

12. For many countries in the region, food prices are a bigger inflationary concern than oil prices since food accounts for a far higher proportion of consumer spending. For example, in the Philippines, food accounts for 50 per cent of the consumer price index (CPI), with energy accounting for only 7 per cent; in India, food represents 46 per cent of CPI; in Indonesia 42 per cent; and in China 33 per cent. Because higher prices for food affect low-income households so severely, Governments may need to consider providing subsidies for the poor in the form of food stamps or cash.

C. Currency appreciation to continue

13. The currencies of countries in the region have appreciated dramatically over the last two years on a tide of huge global liquidity. Since 2006, all major currencies in the region have risen against the dollar. The trend is expected to continue in 2008, in view of the large United States imbalances vis-à-vis the rest of the world and the turmoil in the global financial markets. Between 2006 and November 2007, the won, the currency of the Republic of Korea, rose 7.3 per cent against the dollar, and the Thai baht rose about 17 per cent during the same period of time. However, currencies have not appreciated solely against the dollar; many have also risen against the Japanese yen. The appreciation of currencies against the Chinese yuan is of particular relevance as China competes in third-country markets with other economies of the region.

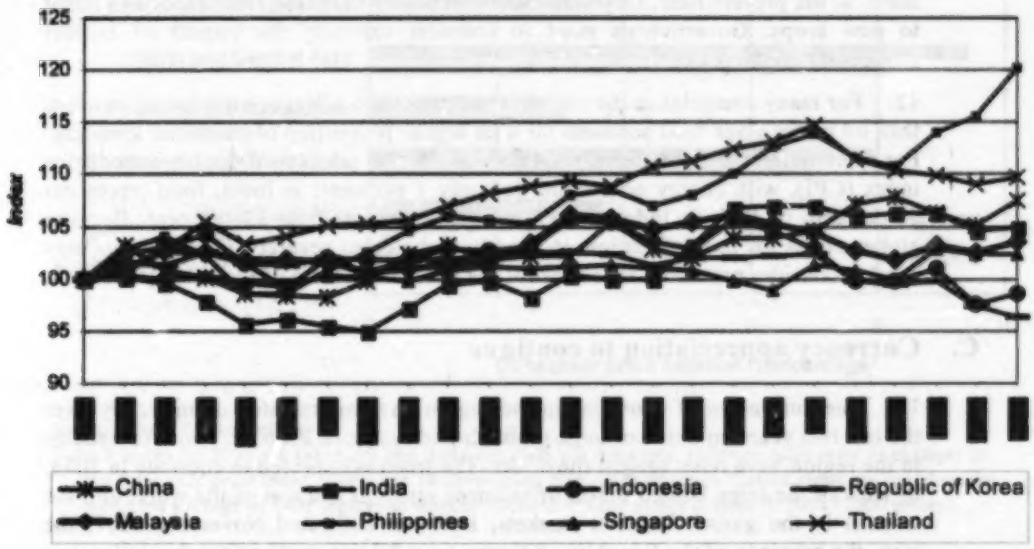
14. The relentless currency appreciation sheltered the region's economies from high oil and food prices, but dealt a blow to the competitiveness of exports. Movements in real effective exchange rates, the best measure for gauging competitiveness, show that all large economies, except those of Indonesia and the Republic of Korea, have experienced appreciation of their currencies since 2006 (see figure III), ranging from 2.4 per cent for Singapore to 20 per cent for the Philippines. Countries of the region have therefore lost export competitiveness not only to the United States but also to other trading partners.

15. Countries experiencing the greatest appreciation in terms of real effective exchange rates since 2006, in particular Thailand and the Philippines, have already seen an impact on their export earnings. Thailand's export growth in dollar terms

fell in the fourth quarter of 2007 (11.6 per cent over the previous year) after rising in the third quarter (11.6 per cent). Export growth in the Philippines became negative in November 2007 (2 per cent year on year), after a rise of 10.5 per cent the previous month.

16. The impact has been greatest in the low technology-intensive manufacturing sector and in other sectors with low import rates, such as agriculture and commodities. In Thailand, local currency export earnings for garments, jewellery, furniture and rubber have been flat since 2006. In the Philippines, textiles, furniture, bananas and pineapples have been most heavily affected.

Figure III
Real effective exchange rates for selected ESCAP economies, 2006-2007[a]



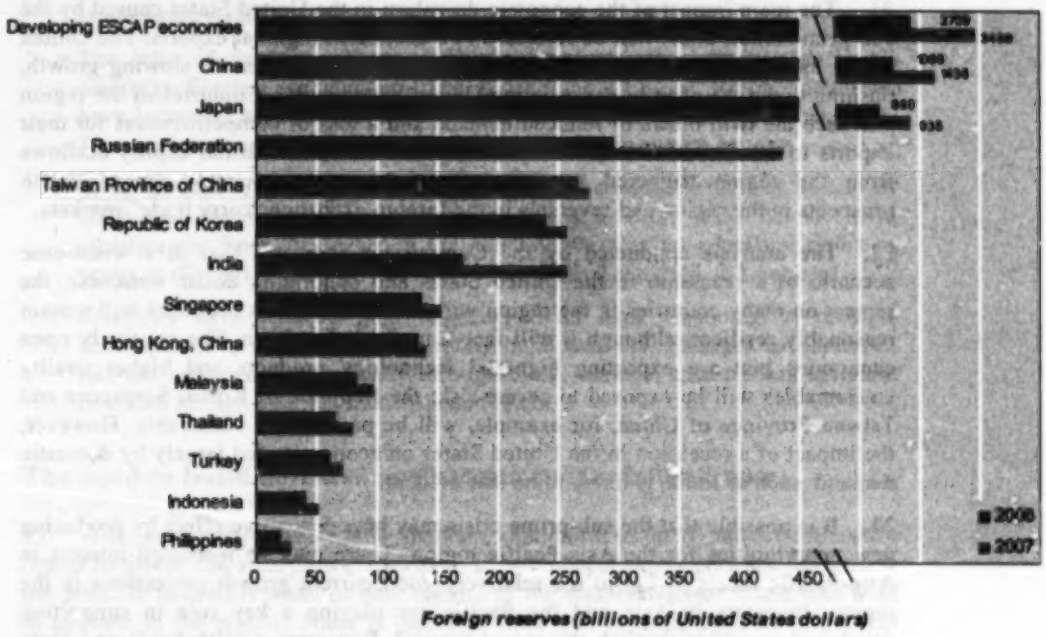
Source: Based on online data from Bank for International Settlements database, available from http://www.bis.org (accessed 17 January 2008).

[a] January 2006 = 100.

D. Reserves accumulate: at what cost?

17. By October 2007, developing economies in the Asia-Pacific region had accumulated $3.4 trillion in foreign reserves, up from $2.7 trillion at the end of 2006 (see figure IV). While reserves have been accumulated partly as a buffer against financial crises, the rapid increase has also been the result of a struggle to control the appreciation of regional currencies. Central banks have been conducting sterilization operations to mop up the excess liquidity created by the accumulation of reserves. Other measures have included increases in bank reserve ratios and interest rates. However, increases in money supply aggregates over recent months indicate that liquidity is continuing to grow.

Figure IV
Major holders of foreign reserves in the Asian and Pacific region, 2006-2007



Source: IMF, International Financial Statistics, CD-ROM (Washington, D.C., 2007).
Note: Foreign reserves exclude gold. Data for 2007 refer to October 2006 or the latest available month.

18. Increasing liquidity has fuelled concerns about inflation. In November 2007, China witnessed its highest inflation in 10 years, and India experienced a two-year high in January 2007 before aggressive tightening lowered prices. In addition to consumer price inflation, liquidity has driven up the prices of other assets, some of which are unrealistic in view of underlying valuations. The price-to-earnings ratio for equities in China is now 59 times 2007 earnings, by far the highest such ratio in Asia. In urban centres in India such as Bangalore and Mumbai housing prices doubled in 2005 and 2006. The Republic of Korea has also seen a substantial rise in property prices in some urban areas.

19. Currency appreciation means that Governments have incurred increased fiscal costs. Foreign exchange reserves have been invested mainly in low-yielding United States Government bonds. Another cost is the loss in the capital value of foreign reserve holdings as the value of the dollar steadily declines.

III. Downside risks to the 2008 outlook: navigating the sub-prime crisis

20. The major risk to the 2008 forecast lies in the spillover effect of the downturn in the United States housing market. Thus far, regional economies have been relatively immune to the tighter credit conditions unfolding in the United States and the member countries of the European Union. The corporate sector in the ESCAP

region is generally cash rich and not highly leveraged. The region is also reported to have had little exposure to holdings of sub-prime and other vulnerable debt.

21. The main impact of the economic downturn in the United States caused by the sub-prime credit crisis will be reflected in a decline in regional exports. The United States has been cutting interest rates aggressively in response to slowing growth, pushing down the already depreciating United States dollar. Countries in the region will face the twin blows of reduced demand and a loss of competitiveness for their exports to the United States. There is also the risk of substantial capital outflows from the region triggered by external developments, concerns about growth prospects in the region and reversals in the foreign exchange "carry trade" markets.

22. The analysis conducted by the Commission indicates that in a worst-case scenario of a recession in the United States and continuing dollar weakness, the impact on many countries in the region will be harsh. China's economy will remain reasonably resilient, although it will face a marked slowdown. The relatively open economies that are exporting high-end technology products and higher quality consumables will be exposed to severe risk: the Republic of Korea, Singapore and Taiwan Province of China, for example, will be particularly vulnerable. However, the impact of a recession in the United States on economies led largely by domestic demand, such as India, is likely to be less evident.

23. It is possible that the sub-prime crisis may have a positive effect by producing new opportunities for the Asia-Pacific region. There may be increased interest in Asia-Pacific assets, owing to the relatively good current growth projections in the region. Investors in Asia and the Pacific are playing a key role in supporting developed countries through the recent turmoil. Sovereign wealth funds and State investment institutions in the region have been major players in bolstering weakened banking sectors in the United States and Europe. The shifting balance of financial power to the region is also evident from the dramatic rise in overseas investments made by the Asia-Pacific corporate sector.

A. Asia and the Pacific well prepared to navigate global instability

24. Asian and Pacific countries and areas have made great progress in reviving their economies since the Asian financial crisis of 1997. As a result, the region is well equipped to navigate global financial and economic instability, as evidenced by the following:

- The region's GDP has doubled since 1997, with per capita incomes now significantly above their pre-crisis values.
- Countries have moved explicitly towards targeting inflation, rather than exchange rates. China and Malaysia widened their exchange rate bands in 2005, and there has been significant currency appreciation since that time. The Philippines, the Republic of Korea and Thailand also saw large appreciations. Removing explicit exchange rate targets reduces the risk of currency mismatches and encourages investors to hedge their currency exposure.
- Government budget deficits have gradually declined and, in some countries, have become surpluses. Concern about exploding public debt is thus limited, with public debt at its lowest level since 2000 in most countries.

- There have been no signs of excessive current account deficits, as there were in the prelude to the 1997 crisis. In fact, post-crisis East Asia is now an exporter of capital to the rest of the world. In 2007, current account surpluses in emerging Asian economies stood at 6.5 per cent of GDP.
- The ratio of foreign exchange reserves to short-term debt is high in all countries. Foreign exchange reserves in developing ESCAP member countries have increased sixfold since 1997, reaching $3.4 trillion as of October 2007. Those reserves can smooth any sudden interruption in capital inflows.
- There has been no excessive build-up of private domestic credit as a share of GDP, and the ratio of non-performing loans to total loans has declined significantly from the levels in the early 2000s. Capital adequacy ratios of banks in the region are well above the international standard of 8 per cent.
- Countries have reduced their dependence on bank financing. A positive development is nascent local currency bond markets. Changes in perceived risk are reflected automatically through those markets, causing less systemic risk than foreign currency-denominated loans.

B. The need to build defences against sub-prime fallout, now

25. With increasingly open capital markets, economies in the region are intimately linked to global financial flows. However, since investor sentiments are fickle, it is not possible to predict when or how turmoil in the financial sector might take hold in markets in the region. There is therefore little that countries can do to prevent external financial sector shocks. Even so, countries can ensure that their economies are strong and flexible enough to weather shocks and adapt to them. Efforts to mitigate the effects of financial shocks are critical because they exact a heavy toll on the poor, who are the least prepared to cope and who suffer the most from any income shock.

26. An effective defence against the effects of a financial crisis includes macroeconomic measures to build resilience to shocks and socio-economic measures to reduce the impact on the poor. In that regard, countries must ensure that they have the following:

(a) Solid macroeconomic fundamentals to maintain investor confidence and sustain economic growth. Key elements are moderate and stable inflation; sound fiscal policies that ensure low budget deficits and sustainable debt burdens; and more flexible exchange rate regimes that can absorb shocks;

(b) Healthy financial sectors to build confidence and benefit from capital inflows. Authorities must keep pace with the increasing diversity and complexity of the new financial products applied in regional markets. Financial markets need to be deepened by developing domestic and regional bond markets;

(c) Robust microeconomic foundations to ensure the efficiency of the economic system, a basic requirement of which is the establishment of clear property rights, overseen by a strong judiciary, allowing companies and institutions to operate effectively;

(d) Social safety nets to protect those facing hardships during economic downturns. Renewed and urgent action is needed now as such systems are difficult

to set up during times of crisis. An effective safety net should be targeted at the poor but should be large enough in scale and coverage to provide broad-based social protection to maintain an adequate standard of living;

(e) Improved regional cooperation, both to prevent crises and to enable countries to react in the event of crises. More needs to be done across the countries of the region to provide an effective early warning system for potentially disruptive flows.

IV. Long-term challenge to the region: addressing the neglect of agriculture

27. Despite good economic performance and the efforts of Governments to foster inclusive development, there are a number of emerging problems in the region. Over 600 million of the world's poor live in Asia, nearly two thirds of the global total. That population lives largely in rural areas and is dependent on agriculture. Addressing the apparent neglect of the agricultural sector should be a regional priority to ensure further progress in reducing poverty and inequality.

28. Agriculture provides employment for 60 per cent of the working population in the Asia and Pacific region. Four decades of neglect of agriculture has, however, weakened the sector's capacity to lower poverty and inequality. Growth and productivity in agriculture have been slowing, and the "green revolution" that boosted agricultural yields in the 1970s has bypassed millions. Pressure on farmers is mounting, as evidenced by declining subsidies, rising input prices, increasing protests over landlessness and an alarming number of suicides among those living in debt.

A. Agriculture: a powerful driver of poverty reduction and social equity

29. Increased economic growth is only one aspect of efforts to reduce poverty. The regions and sectors of growth are also important. Poverty in India can more easily be addressed through rural economic growth than urban economic growth. It must be kept in mind that differences in initial conditions related to rural development and human resources development lead to different outcomes, and that agricultural productivity and public expenditure on rural development are important determinants of poverty.

30. Agricultural labour productivity has a significant impact on poverty reduction. Estimates by the Commission show that a 1 per cent increase in agricultural productivity would lead to a 0.37 per cent drop in poverty in the Asia-Pacific region. Given the large agricultural labour productivity gaps among countries in the region, the potential gains appear to be substantial. According to the ESCAP analysis, raising the region's average agricultural productivity level to that of Thailand's, the

benchmark for the analysis, would lift 218 million people out of poverty.[1] India has the most to gain from a productivity drive, with nearly two thirds of the total poor in the region and a large agricultural productivity gap.

31. Investment, literacy and agricultural productivity reduce income inequality, and increases in agricultural value added are even more effective in reducing income inequality since they have a disproportionate impact on the lowest income groups. The Commission's estimates indicate that raising agricultural productivity levels to that of Thailand could reduce inequality by 6 per cent, as represented by the Gini coefficient.

32. Agricultural research and development, education of the rural population and reinforcement of rural infrastructure, including electricity and roads, are key determinants of labour productivity that have a major impact on poverty reduction. There is also strong evidence that agricultural productivity has a significant impact on human capital development.

B. Liberalization of agricultural trade and its impact on poor farmers

33. The liberalization of trade in agricultural products and its impact on developing economies has been a historically contentious issue in international trade negotiations, including the Doha Development Round. Developing countries have thus far been cautious in instituting multilateral agricultural trade reforms owing to the possible harm that might be caused to economies through preference erosion and rising agricultural prices for small food-importing economies, as well as the possible adverse effects on food security and poverty.

34. The Commission's analysis of the impact of agricultural trade liberalization under the Doha reforms reveals a reduction in poverty in some countries and an increase in others. In the Asia-Pacific region, in the short run, 5 million people living on less than one dollar a day could be lifted out of poverty through agricultural trade reforms under the Doha Round, with a possible increase to 7 million in the long run. In China, possible gains appear to be the most dramatic, with the number of poor people being reduced by as many as 10 million, mainly in rural areas, through an increase in the real wages of unskilled workers. In Thailand and Viet Nam, the prevalence of poverty would also be reduced, as well as in Indonesia and the Philippines. Poverty would increase, however, in Bangladesh, India, the Russian Federation and Sri Lanka in both the short and the long run. India would suffer the most, with 7.2 million additional poor, owing to the negative impact on the real wages of unskilled labourers.

35. If the countries go beyond the Doha reforms and undertake comprehensive agricultural liberalization, eliminating all tariffs, export subsidies and domestic support for agricultural and food products, 48 million people could be lifted out of poverty in the Asia-Pacific region over the short run, and possibly 51 million in the

[1] The agricultural labour productivity rate prevailing in Thailand was taken as the benchmark for several reasons: it is one of the few countries in the region that has achieved most of the Millennium Development Goals, and agriculture has contributed much towards the achievement of those targets. In addition, the productivity levels prevailing in better performing countries (such as Malaysia, the Republic of Korea and Singapore) are either relatively high or not representative.

long run. In all countries, except Sri Lanka, there would be a reduction in the level of poverty. In rural China nearly 25 million people could rise out of poverty, and in India 12 million.

36. Many other studies find that agricultural trade reform may have a positive impact on developing economies. In China, the urban-to-rural income ratio declines under global trade liberalization scenarios, although not significantly. The results also suggest that the largest increases in welfare would accrue to rural households. In Indonesia, the impact on inequality would be negligible, but rising incomes would boost a small number of people out of poverty.

C. Creating a socially and economically viable agricultural sector: a two-pronged approach

37. Since the majority of the poor live in rural areas and depend heavily on agriculture for their survival, it should be a regional policy priority to revitalize agriculture. Some of the poor will remain in the agricultural sector and will continue to make their primary livelihood from farming. Others, however, will move from that sector to industry or services, which offer better employment opportunities and a chance to escape from poverty. Policies should be put in place to make the transformation easy. Agriculture alone will not raise the 641 million poor people in the Asia-Pacific region out of poverty. Developing the non-farm sector is equally important. The survey proposes a two-pronged strategy to ensure that agriculture is both economically and socially viable, restoring its vital role as an engine for reducing poverty and inequality.

38. First, agriculture needs revitalization. That requires a market orientation with a focus on quality and standards. Investment needs to be made in research and development in order to improve agricultural productivity. In addition, investment must be made in health, education and technological innovation in this sector. Land policies, which connect the rural poor to cities and markets, must be revised, and credit instruments and crop insurance must be made readily available to those in farming communities.

39. Second, facilitating the movement of people from the agricultural sector should complement agricultural development, including by empowering the poor, particularly women, improving skills to tap labour market opportunities and promoting rural non-farm activities and regional growth centres. Public policy should support both tracks, thus levelling the playing field for poor and rich.

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Latin America and the Caribbean: economic situation and outlook, 2007-2008

Summary

The favourable economic conditions and strong growth performance the Latin American and the Caribbean region has been enjoying virtually across the board since 2003 continued in 2007. The region was confronted with a worsening external financial situation, however, caused by a high level of volatility in international financial markets and rising uncertainty, both largely the result of the crisis originating in the financial market of the United States of America. Despite this, most of the region's economies continued to grow at a brisk pace thanks to strong domestic demand, which was driven by private consumption and gross capital formation. In this context, Latin America and the Caribbean registered a growth rate of 5.7 per cent in 2007; the region has thus been growing at rates in excess of 4.5 per cent for four years running.

The region continued to feel the benefits of strong external demand and of the high prices being fetched by its main export products. In regional terms, the volume of goods and services exported increased by 5.3 per cent and terms of trade were up by 2.4 per cent. These increases, combined with a rise in remittances from abroad, swelled the region's gross disposable national income in 2007 at a rate (6.5 per cent) that, like in 2006 and 2005, outstripped gross domestic product (GDP) growth.

In 2008, growth is expected to slacken slightly, with regional GDP rising by around 4.7 per cent. If these projections are borne out, the region's per capita output will have seen a cumulative increase of about 22.5 per cent in the period 2003 to 2008, equivalent to an average of 3.4 per cent per year.

* E/2008/100.

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I. Introduction

1. The economy of the Latin American and Caribbean region grew by 5.7 per cent in 2007, equal to a 4.3 per cent rise in per capita gross domestic product (GDP) (see table 1).

Table
Gross domestic product growth rates
(Constant 2,000 United States dollars, percentage)

Country	*2005*	*2006*	*2007*
Argentina	9.2	8.5	8.7
Bolivia	4.0	4.6	4.6
Brazil	2.9	3.7	5.4
Chile	5.7	4.0	5.1
Colombia	4.7	6.8	7.5
Costa Rica	5.9	8.2	6.8
Cuba[a]	11.8	12.5	7.5
Dominican Republic	9.3	10.7	8.5
Ecuador	6.0	3.9	2.7
El Salvador	3.1	4.2	4.7
Guatemala	3.5	4.9	5.7
Haiti	1.8	2.3	3.2
Honduras	4.1	6.0	6.3
Mexico	2.8	4.8	3.3
Nicaragua	4.3	3.7	3.8
Panama	7.2	8.7	11.2
Paraguay	2.9	4.2	6.0
Peru	6.7	7.6	9.0
Uruguay	6.6	7.0	7.4
Venezuela (Bolivarian Republic of)	10.3	10.3	8.4
Subtotal Latin America[b]	**4.6**	**5.5**	**5.7**
Subtotal Caribbean	**4.7**	**6.9**	**3.9**
Latin America and the Caribbean[b]	**4.6**	**5.6**	**5.7**

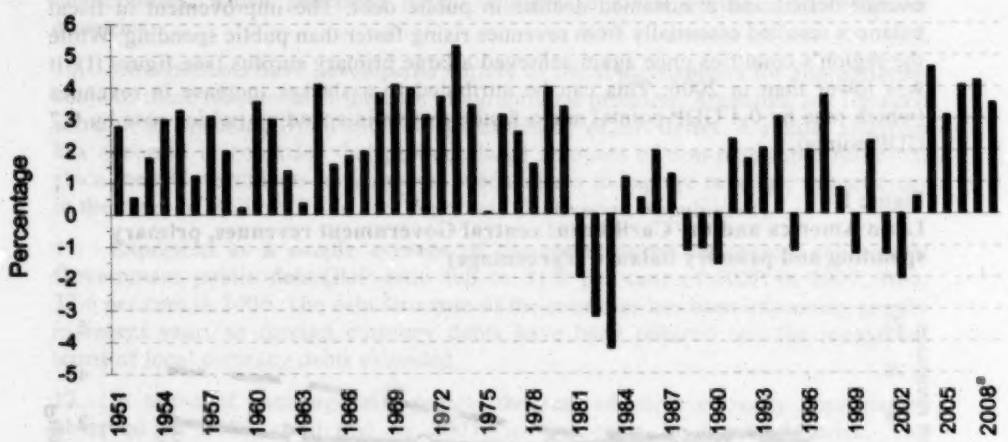
Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.
[a] Data provided by the National Statistical Office of Cuba.
[b] Does not include Cuba.

2. Thus, 2007 marked the fifth consecutive year of growth and the fourth at a rate of over 4 per cent. The last period of sustained per capita GDP growth of over 3 per cent per year occurred 40 years ago, in the period between the late 1960s and the first oil price shock of the early 1970s, when the region's economy expanded at comparable rates for seven years in a row (see figure I).

Figure I

Latin America and the Caribbean: per capita gross domestic product

(Annual growth rates)



Source: ECLAC, on the basis of official figures.

[a] Projection.

3. In 2008 growth is expected to slacken slightly, with growth of around 4.7 per cent in regional GDP. If this occurs, per capita GDP in the region will have increased around 22.5 per cent in the period from 2003 to 2008, equivalent to an average of 3.4 per cent per year.

4. In the past few years, the world economy has experienced exceptional growth rates, growing at over 3 per cent annually for four years running. Thus, the performance of the Latin American and Caribbean economies is not an isolated occurrence but is taking place rather against a general backdrop of growth. In this connection, it should be noted that, while the region's growth rates are high by historic standards, they are not high by comparison with those in other regions of the developing world.

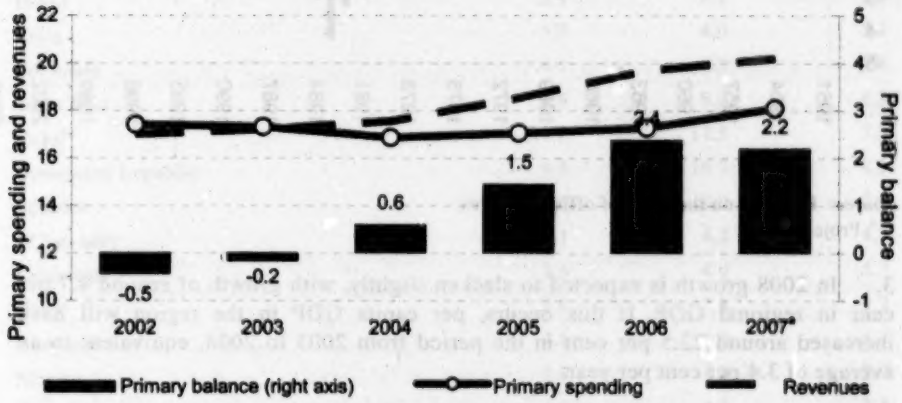
5. During 2007, many of the characteristics of the current economic growth phase continued to be observed. These features include a continuing (albeit substantially smaller than in 2006) current-account surplus, a further (although less marked) improvement in the terms of trade, a continuing positive primary balance in fiscal accounts, falling unemployment, rising international reserves and lower external debt as a percentage of GDP. However, some alterations in the trends of recent years have been observed, which undoubtedly represent an economic policy challenge. Some of the developments include a steeper increase in public spending, which represents a setback in relation to the overall fiscal balance achieved by the region in 2006; a weakened momentum of the exports of goods, whose volume grew by less than GDP for the first time in many years; a rise in inflation, which interrupted the downward trend of the past four years; and an increase in the sovereign risk of the region's countries against the backdrop of the financial market turbulence that began in May 2007.

II. Economic policy

6. Some of the characteristics of 2007 differed from those of the 2002-2006 period, since the latter was characterized by a growing primary surplus, a falling overall deficit and a sustained decline in public debt. The improvement in fiscal balances resulted essentially from revenues rising faster than public spending. While the region's countries once again achieved a large primary surplus (see figure II), it was lower than in 2006. This can be attributed to a slacker increase in revenues (which rose by 0.4 GDP points) and a faster growth in spending (which rose by 0.7 GDP points).

Figure II

Latin America and the Caribbean: central Government revenues, primary spending and primary balance (Percentage)



Source: ECLAC, on the basis of official figures.

* Preliminary figures.

7. At the level of central Governments, the fiscal performance of the region's countries indicated that they were running primary surpluses averaging 2.2 per cent of GDP (simple average) at the end of 2007, compared with a surplus of 2.4 per cent in 2006. Conversely, the overall balance, which includes interest payments on the public debt, worsened from 0.1 per cent to -0.1 per cent of GDP.

8. The above-mentioned average primary surplus reflects a fiscal performance that is common to almost all the countries in the region. Of the 19 countries for which information is available, 16 achieved a primary surplus in 2007 (only Haiti, Honduras and Guatemala ran a primary deficit). This is a major contrast to the situation in 2002, when just eight countries presented a surplus. Despite these results, the number of countries showing a deterioration in their fiscal balance increased. In 2007, 12 of the 19 countries analysed recorded a larger deficit or a smaller surplus. This stands in contrast to the situations in 2006 and 2005, when most of the countries recorded an improvement in their indicators. Fuller coverage of some selected countries also reveals a deterioration in the primary balance of the non-financial public sector, which fell on average from 4.1 per cent to 3.3 per cent of GDP between 2006 and 2007.

9. A number of factors have come together in the past few years to raise the fiscal revenues of the countries in the region: a substantial increase in economic activity, which has major implications for tax collections; low inflation in most of the countries; improved tax collection mechanisms; and higher prices for certain commodities, which generated larger volumes of fiscal revenues for producer countries.

10. Governments have developed a variety of fiscal mechanisms for appropriating some of these resources. In the case of agricultural products, Argentina has financed some of its spending from resources generated by export duties. A similar situation has occurred in countries that produce large amounts of non-renewable resources since their Governments have created mechanisms to capture revenue, in particular in the cases of Bolivia, Chile and Venezuela (Bolivarian Republic of).

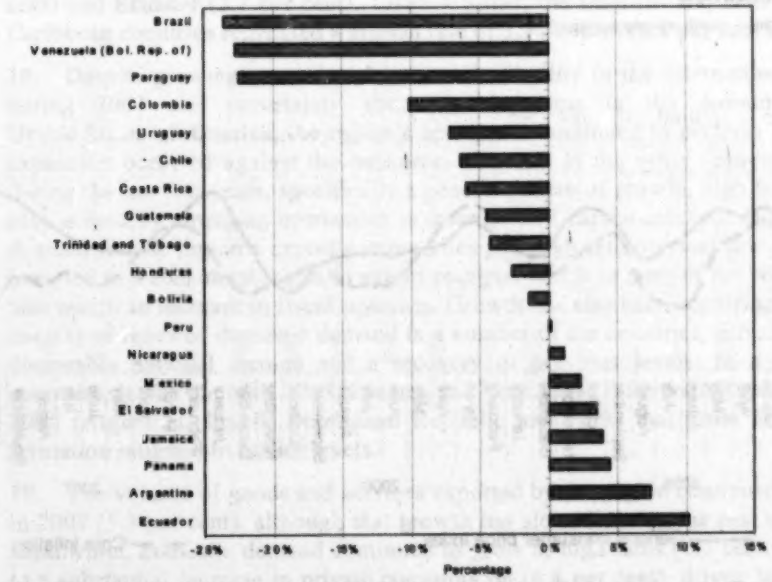
11. Expressed as a simple average of the countries of the region, the central Government public debt/GDP ratio fell to 31.8 per cent of GDP in 2007, from 37.6 per cent in 2006. The debt structure of the countries has been improving greatly in recent years as foreign currency debts have been reduced and the repayment terms of local currency debts extended.

12. In terms of exchange rate policy, the real effective currency appreciation observed in 2006 continued in 2007, in particular in South America. The extraregional exchange rate of Latin America and the Caribbean (which excludes trade among the countries in the region) appreciated by 2.7 per cent, with effective appreciations registered in 11 countries during the period. Figure III shows the evolution of total effective exchange rates since 2005 and the process of exchange rate appreciation in the region.

Figure III

Latin America and the Caribbean: total real effective exchange rate variation

(Average for 2007 compared to average for 1990-1999)



Source: ECLAC, on the basis of official figures.

13. Together, the countries of South America recorded an appreciation of 4.8 per cent, while Central America, Mexico and the Caribbean registered an effective extraregional appreciation of 0.3 per cent during the period. Currency appreciation in South America in 2007 occurred in a context where the commodities exported by the subregion were fetching high prices and a number of countries were receiving substantial capital inflows.

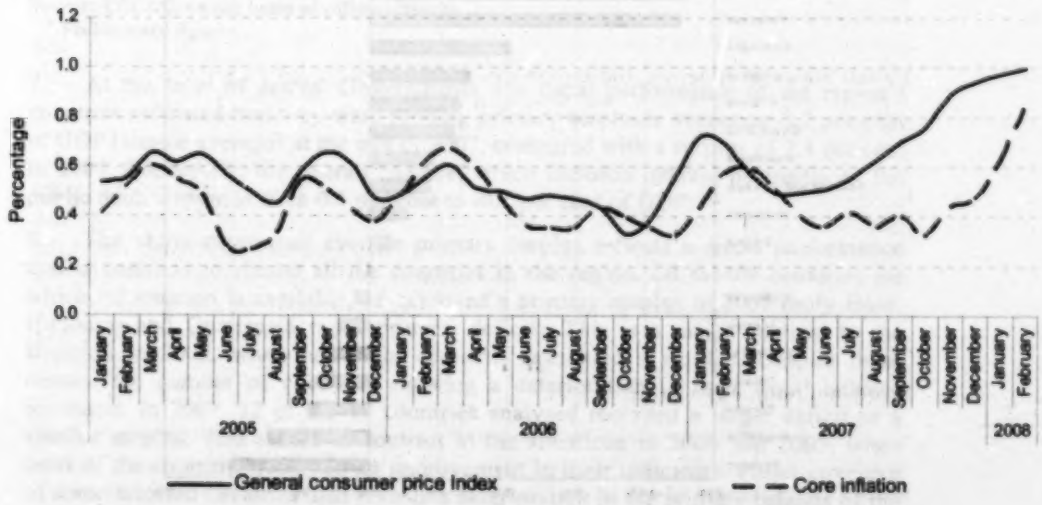
14. Although inflation in the region in 2007 was still low by historical standards, countries with an inflation target regime (including Brazil, Chile, Colombia, Mexico, Paraguay and Peru) or an inflation target range (such as Costa Rica, Guatemala and Honduras) saw consumer prices increase by more than the inflation target set by their central banks. In a number of countries, even core inflation came in over target. Most of the central banks reacted by raising interest rates. As the United States Federal Reserve lowered its monetary policy rate and the countries of the Latin America and Caribbean region increased theirs, the yield differential widened. Despite this, interest rates in the region have remained low by comparison with historic rates; this has contributed to a strong rise in bank lending, in particular consumer lending, which was the type of credit to increase the most, and mortgage lending.

15. The inflation rate in Latin America and the Caribbean was 6.4 per cent in 2007, which represents an increase over 2006 (5.0 per cent), cutting short the gradual decline in this indicator at the regional level since 2002 (see figure IV). It also reflects the sharp rise in prices for some goods and services, including food (especially cereals, oleaginous products and oils, meat and some beverages), fuels and basic services. The situation was compounded in some countries by supply constraints. In several countries, currency appreciation partially offset the effect on domestic prices of the higher prices of imported products.

Figure IV

Latin America and the Caribbean: monthly variation in consumer price indexes and core inflation

(Unweighted three-month moving averages)



Source: ECLAC, on the basis of official figures.

16. Trends in inflation and the behaviour of the exchange rate have presented the region's economic authorities with certain policy dilemmas. Further hikes in interest rates to curb inflationary pressures will contribute to further currency appreciation. This judgement is largely based on the higher level of real interest rates which, together with good country risk ratings, has helped to increase capital inflows. The capital inflows, combined with the larger currency inflows associated with increased exports, have led to increases in international reserves and hence in monetary aggregates, forcing central banks to redouble their efforts to soak up liquidity, with the resulting cost in terms of monetary policy. Whether the dilemma between inflation and appreciation continues into 2008 depends on a number of factors, in particular the monetary policy of the United States Federal Reserve and the perception of central banks concerning the causes of rising inflation.

III. Domestic performance

17. In 2007, the economic growth tendencies of earlier years continued and the expansion spread to all the countries in the region; while several countries experienced higher growth rates than in 2006, others slowed down. The following had higher growth rates: Brazil, 5.4 per cent (3.7 per cent in 2006), Chile 5.1 per cent (4.0 per cent in 2006), Panama 11.2 per cent (8.7 per cent in 2006), Paraguay 6.0 per cent (4.0 per cent in 2006) and Peru 9.0 per cent (7.6 per cent in 2006). In Mexico, economic activity slowed down, with the growth rate falling from 4.8 per cent in 2006 to 3.3 per cent in 2007. Although the rate of GDP growth in the Dominican Republic and Venezuela (Bolivarian Republic of) declined in 2007, these countries are still among those that are expanding strongly in the region. Panama and Peru had the highest growth rates, followed by Argentina (8.7 per cent), the Dominican Republic (8.5 per cent), and Venezuela (Bolivarian Republic of) (8.4 per cent). The countries with the lowest rates were Mexico (3.3 per cent), Haiti (3.2 per cent) and Ecuador (2.7 per cent). Taken together, the English- and Dutch-speaking Caribbean countries registered a growth rate of 3.9 per cent (6.9 per cent in 2006).

18. Despite growing turmoil and increased volatility in the international markets during 2007 and uncertainty about developments in the economy of the United States of America, the region's economies continued to perform well. Their expansion occurred against the backdrop of trends in the other economic regions during the last few years, specifically a general pattern of growth, high liquidity and easy access by emerging economies to international capital markets. High external demand for the region's export commodities and high international prices for them have led to a considerable rise in export receipts, which in most of the countries has also meant an increase in fiscal revenues. Growth has also been occurring within the context of renewed domestic demand in a number of the countries, driven by higher disposable national income and a recovery of previous levels. In a number of countries, it was not until 2005 (Panama and Venezuela (Bolivarian Republic of)) or 2006 (Argentina, Brazil, Dominican Republic and Peru) that gross fixed capital formation returned to earlier levels.

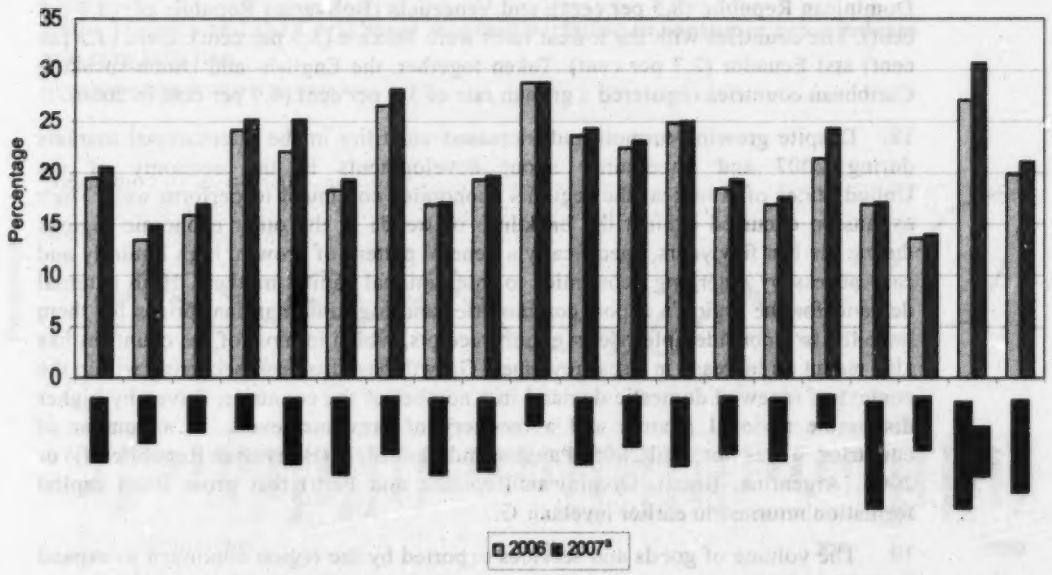
19. The volume of goods and services exported by the region continued to expand in 2007 (5.3 per cent), although that growth has slowed during the past three years. Meanwhile, domestic demand continued to grow at high rates (7.7 per cent) owing to a substantial increase in private consumption (6.8 per cent), driven by improved employment indicators, a modest rise in real wages, persistently low interest rates in

a number of countries, which provided a stimulus to consumer lending, and currency appreciation, which brought down the prices of imported final consumption goods.

20. The rate of expansion in 2007 in gross fixed capital formation (12.2 per cent) was similar to the rate in 2006 (12.9 per cent), making this the component of demand that had grown the most over the past four years; indeed, regional gross fixed capital formation grew by a cumulative 59 per cent between 2003 and 2007. The rise in regional fixed capital investment is due mainly to the rapid growth of investment in plants and equipment, most of it imported, a development due in part to the appreciation of most of the countries' currencies against the United States dollar and by rising domestic and external demand. Meanwhile, the construction sector slowed slightly.

21. Regional gross fixed capital formation, expressed as a percentage of GDP and in constant dollars, continued to increase, reaching 21.1 per cent in 2007, as compared to 19.9 per cent in 2006. This is still considerably lower than the levels reached in the 1970s but it represents a substantial increase over the lows of 2002 (16.8 per cent) and 2003 (16.4 per cent). The regional total is heavily influenced by the figures from Brazil, which accounts for about 30 per cent of the region's gross fixed capital formation and has one of its lowest investment ratios (16.9 per cent), along with Bolivia, the Dominican Republic, El Salvador, Paraguay and Uruguay, (see figure V).

Figure V
Latin America: gross fixed capital formation as a percentage of GDP[a]
(Constant 2000 United States dollars)



Source: ECLAC, on the basis of official figures.
[a] Estimate.

22. In current dollars, regional investment has also continued an upward trend. Expressed as a percentage of GDP, gross fixed investment rose to 20.7 per cent in 2007, from 20.2 per cent in 2006. As in earlier years, the levels of investment were financed entirely out of national saving, given the persistence of negative external saving in the region. The national saving rate in the region was 21.2 per cent in 2007 (21.8 per cent in 2006), while the negative external saving, which has been a feature of the region since 2003, narrowed from -1.7 per cent of GDP in 2006 to -0.7 per cent. The sharp rise in domestic demand in the region was reflected in a rising volume of goods and services imports (13.4 per cent). Given that this aggregate has been consistently rising faster than the volume of goods and services exports since 2004, net exports have been making an increasingly negative contribution to regional GDP growth.

23. Growth in demand had its counterpart in the performance of the various sectors of economic activity. Regionally, the most dynamic sectors were transport and communications, construction, trade, and financial and business services. Greatly improved cereal harvests (Argentina, Paraguay) and the growing of export crops (Costa Rica, Honduras, Panama) resulted in a substantial expansion of the agricultural sector; in other countries, poor weather conditions affected performance (Bolivia, Chile). Mining expanded only very modestly in the region as a whole, although output in Chile rose as new workings came on stream. The industrial sector continued to grow at about the same rate as in 2006, owing to rising domestic and external demand. At the regional level, the performance of the construction sector was uneven. Argentina, Colombia, Chile, Costa Rica, Ecuador, Guatemala, Honduras, Mexico, Nicaragua, Paraguay, Uruguay and Venezuela (Bolivarian Republic of) saw a marked slowdown in this sector, although some of them posted double-digit growth rates (Colombia, Costa Rica, Dominican Republic, Panama, Peru and Venezuela (Bolivarian Republic of)). At the same time, the upswings in domestic credit, financial transactions and domestic economic activity were reflected in the expansion of financial and business services. The momentum of the international economy and the stronger growth in general in the Latin American countries helped to drive an increase in recreational and business travel. In 2007, tourist arrivals were up by 10.3 per cent in Central America and 8.1 per cent in South America and down by 1 per cent in the Caribbean. Sharp rises in commodity prices and in the export revenues of the region's countries meant that, region-wide, the terms of trade effect remained favourable in 2007. Although many imported products rose in price, in particular food and energy, the prices of manufactures increased only very slightly, so that the purchasing power of the region's exports continued to grow. The trade gains resulting from the improvement in the terms of trade amounted to 3.7 per cent of GDP in 2007 (3.1 per cent in 2006), the main beneficiaries being the South American countries and Mexico.

24. This situation, combined with a slight drop in net factor payments to the rest of the world (although these are still high) and a steady increase in net current transfers from the rest of the world, meant that gross disposable national income in the region's countries rose by more than GDP for the fifth year running, increasing by 6.5 per cent in 2007 (7.1 per cent in 2006). In terms of the subregional picture, however, this aggregate expanded at a slower rate than economic activity in the Central American countries, owing to slower growth in emigrant remittances and the negative impact of the terms of trade.

25. The need to create sufficient high-quality jobs continues to be one of the main concerns in the region. Job creation remained high in 2007, with the regional employment rate rising by 0.5 percentage points, from 54.1 per cent to 54.6 per cent of the working-age population. The labour participation rate edged up from 59.4 per cent to 59.5 per cent; the rise in the employment rate was thus reflected in a further fall in the unemployment rate, from 8.6 per cent to 8.0 per cent (see figure VI). The unemployment rate not only fell again in the region as a whole but also in 16 out of the 18 countries for which information was available. In the past five years, unemployment in the region has dropped by three percentage points, coming close to the levels of the early 1990s. The number of urban unemployed fell by about 800,000 in 2007, leaving the total of urban unemployed people at a little less than 17 million. This reveals a continuing situation of very serious unemployment, closely linked to high, though falling, levels of poverty.

26. Real wages showed only a slight increase in most of the countries, continuing the tendency observed in the current period of economic growth for labour dynamics to be reflected in job creation, but to a much lesser extent in wages.

Figure VI
Latin America (9 countries): Quarterly employment and unemployment rates
(Weighted average, percentage)

Source: ECLAC, on the basis of official figures.

27. Developments in labour supply were uneven. While labour participation rates rose in a number of countries, they fell in Argentina, Mexico and Venezuela (Bolivarian Republic of). In most of the countries that posted a rise in labour-market participation, the increase was, as in earlier years, related to increased participation by women; while the rate for men, however, continued its slow decline, mainly as a result of young men staying longer in the education system.

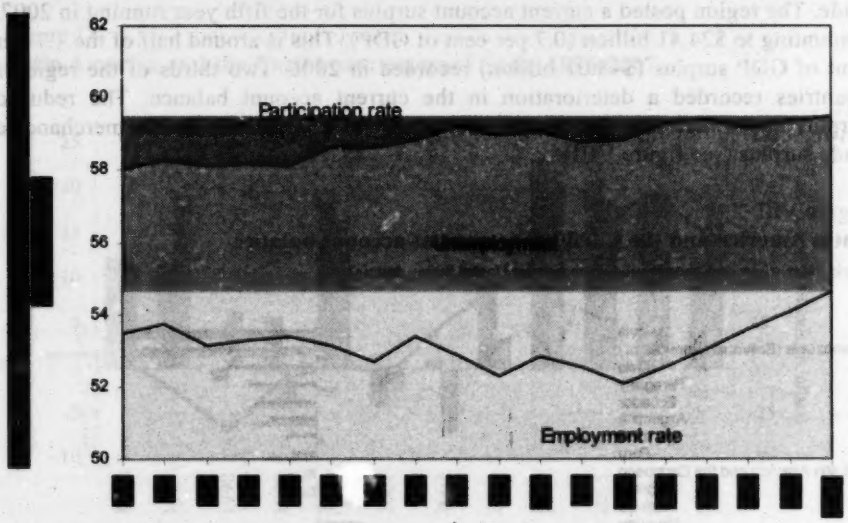
28. In contrast with the uneven figures for labour-market participation, the employment rate rose in almost all the countries; it fell only in two: Honduras and

Trinidad and Tobago. In the past five years, the employment rate for the region has risen by 2.5 percentage points. This not only has made up for the earlier fall but also represents an increase of 1.5 percentage points over the region's average employment rate for the 1990s (see figure VII).

29. The most notable characteristic of the rising employment rate in the 2003-2007 period of growth is that the significant increase in job numbers is concentrated in waged employment. The main exceptions were Brazil and Peru, where there were notable increases in self-employment. This does not mean, however, that the labour demand had weakened in those cases, in particular since waged employment, especially formal waged employment, continued to increase strongly.

Figure VII

Latin America and the Caribbean (16 countries): participation, employment and unemployment rates, as a proportion of the working-age population



Source: ECLAC, on the basis of official figures.

[a] Preliminary figures.

30. Employment as a whole rose by 2.8 per cent in 2007 (similar to the previous year's figure) and waged employment by 4 per cent. The strong upward trend in formal waged employment also continued in 2007. As in previous years, high rates of increase suggest that the upturn is due not only to new job creation but, in part, to the formalization of pre-existing jobs. The combination has boosted the size of the formal sector, measured by the indicator of registered employment or by the number of those contributing to social security systems. In the past five years, formal employment has risen by about 17.5 per cent in Mexico, 25.3 per cent in Brazil, 31.2 per cent in Chile, 26.9 per cent in Peru, 29.3 per cent in Costa Rica, 47.6 per cent in Nicaragua and 49.5 per cent in Argentina.

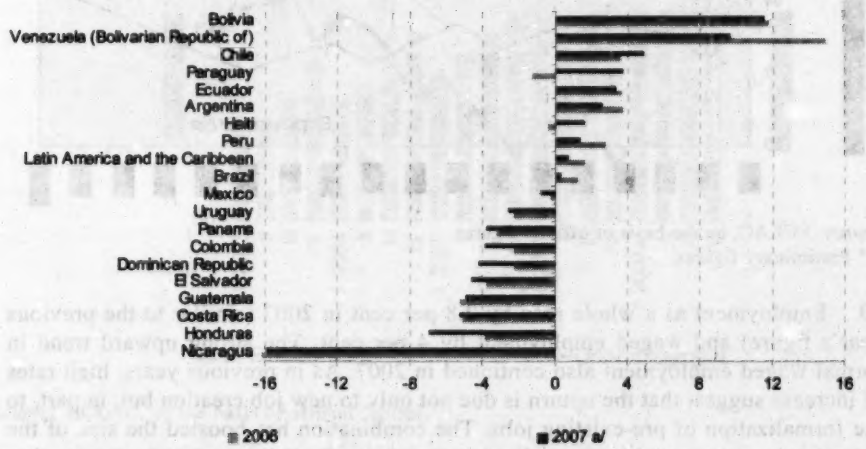
31. This does not mean, however, that there has been a general improvement in employment quality. Although the indicators relating to the volume of employment improved fairly generally, as tends to be the case when open unemployment is falling, when other indicators are used, performance appears more uneven. One

matter for concern is the growing lack of stability in formal contracts, reflected in a rise in fixed-term contracts (in Colombia and Mexico, for example). Real wages in the formal sector showed only a slight increase or even a decrease in most of the countries and, considering the region as a whole, real wages increased by 1.5 per cent as a weighted average. There has thus been a continuation of the pattern of the past few years, in which rising labour demand has had a strong impact on job creation, but much less of an impact on wages.

IV. The external sector

32. Despite worsening turmoil in the financial markets during 2007 and uncertainty over the performance of the United States economy, external conditions remained favourable for the region's countries throughout the year, thanks to robust international demand for their export commodities and an increase in intra-regional trade. The region posted a current account surplus for the fifth year running in 2007, amounting to $24.41 billion (0.7 per cent of GDP). This is around half of the 1.7 per cent of GDP surplus ($48.01 billion) recorded in 2006. Two thirds of the region's countries recorded a deterioration in the current account balance. The reduced surplus in the region is due almost exclusively to a large drop in the merchandise trade surplus (see figure VIII).

Figure VIII
Latin America and the Caribbean: current account balance
(Percentage of gross domestic product in current United States dollars)



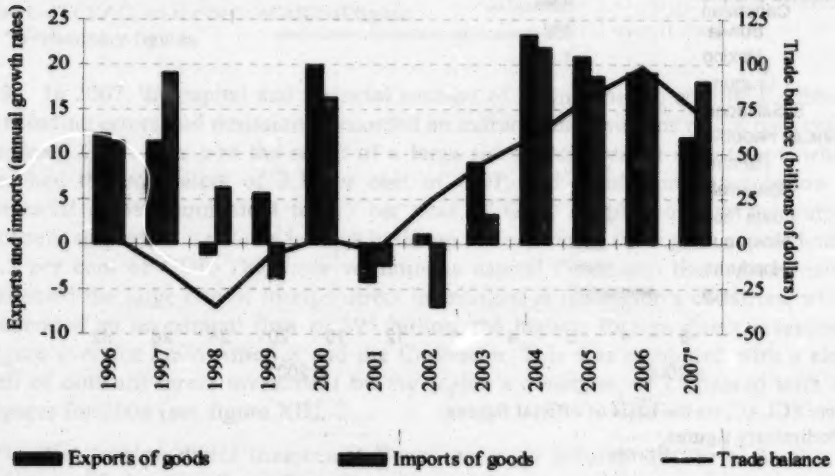
Source: ECLAC, on the basis of official figures.
[a] Preliminary figures.

33. In 2007, total Latin American exports rose by 12.2 per cent to reach $752.26 billion. Imports, however, grew more quickly, at a rate of 18.2 per cent, to reach US$ 677 billion. Although the region registered a positive merchandise trade balance for the sixth year running, equivalent to 2.2 per cent of GDP, the upward trend that had been in evidence since 2002 was reversed in 2007 (see figure IX). The increase in merchandise exports had as much to do with higher prices (6.3 per

cent) as higher volumes (5.3 per cent). The higher prices of the region's exports were due largely to rises in commodity prices, which continued to climb throughout 2007. Despite the rise in export volumes in the region as a whole, the volumes fell in some petroleum-producing countries (Ecuador, Mexico, and Venezuela). The countries that have posted the largest increases in export volumes are Paraguay (26.7 per cent) (thanks to high soybean sales), Panama (13.6 per cent), Guatemala (9.6 per cent) and Costa Rica (9.3 per cent). Argentina (8.3 per cent) and Brazil (7.8 per cent) have also expanded their export volumes considerably, thanks to buoyant manufactures and primary products.

34. As for merchandise imports, most of the increase was due to a rise in volumes, of 13.5 per cent for the region as a whole and of more than 20 per cent in five countries: Brazil and Peru (26 per cent in each), Venezuela (Bolivarian Republic of) (25 per cent) and Argentina and Colombia (22 per cent in each). If these trends continue, the trade surplus could well undergo a reversal in the next few years.

Figure IX
Latin America and the Caribbean: external trade, 1996-2007



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

[a] Preliminary figures.

35. For the region as a whole, the ongoing services deficit reached $24.8 billion (-0.7 per cent of GDP). This result is due largely to the transport deficit (only Panama and Chile are major exporters of transport services). Other business services also posted deficits, especially in Brazil. Some countries, however, such as Argentina, Brazil, Chile and Uruguay, began to post healthy figures in exports of software services and certain business services (although these were much lower than in countries like India).

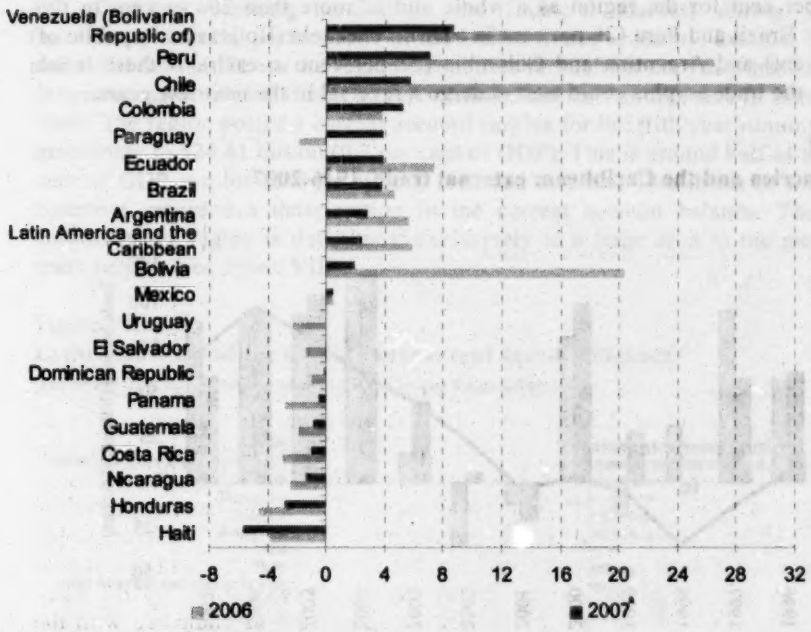
36. Terms of trade for Latin America and the Caribbean were up for the sixth year in a row. From 2003 to 2007, the indicator grew by 19 per cent. However, change is under way in the factors that have been conducive to regional terms of trade (see

figure X). In 2006, there was a 5.9 per cent improvement in the region's terms of trade, but it dropped to 2.4 per cent in 2007. Nevertheless, countries such as Chile, Peru and Venezuela (Bolivarian Republic of) have made striking gains thanks to increases in the prices of their main export products. In general, the terms of trade of Central American countries continue to be far less favourable.

Figure X

Latin America and the Caribbean: variation in merchandise terms of trade, f.o.b./f.o.b.

(Percentage)



Source: ECLAC, on the basis of official figures.

[a] Preliminary figures.

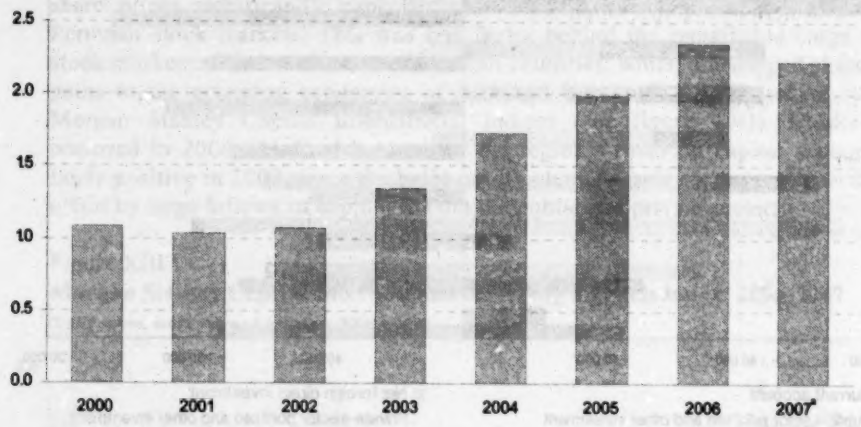
37. Current transfers, mainly in the form of emigrant remittances, were moderately affected by the economic slowdown in the United States. Indeed, the positive transfers balance increased by 5 per cent in 2007 (compared with almost 20 per cent in 2006) to stand at around $62.5 billion.

38. The income balance was very similar to the previous year, with a deficit of $88 billion. As shown in figure XI below, the repatriation of profits and dividends has expanded significantly in recent years (see figure XI). This item has increased substantially in Costa Rica, Chile (resulting from the profits of foreign mining companies) and Brazil (mainly from returns on short-term financial placements on the fixed-income market, which have benefited from the higher prevailing interest rates in the country (carry trade)).

Figure XI

Latin America and the Caribbean: repatriation of profits

(Percentage of gross domestic product in current United States dollars)



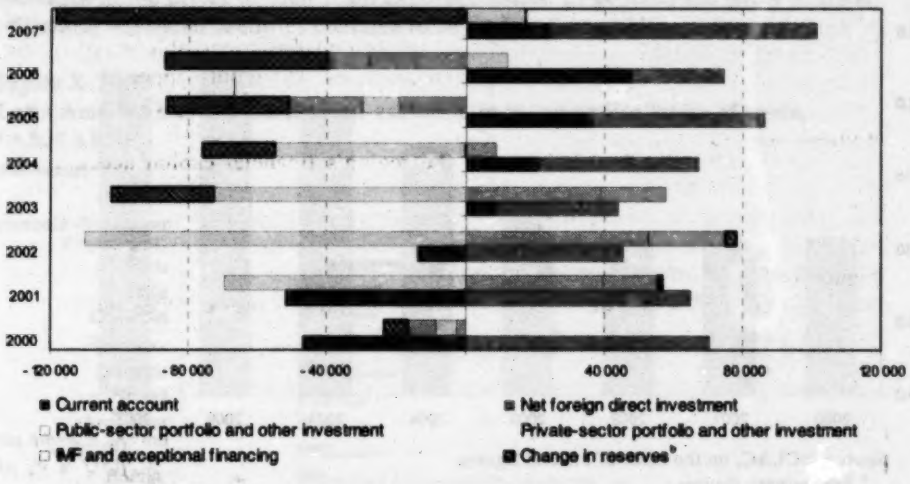
Source: ECLAC, on the basis of official figures.

[a] Preliminary figures.

39. In 2007, the capital and financial account of Latin America and the Caribbean (including errors and omissions) recorded an extraordinary surplus of 2.8 per cent of regional GDP. This was the result of a large rise in net foreign investment, which reached the equivalent of 2.3 per cent of GDP, and a substantial net inflow of financial capital equivalent to 0.5 per cent of GDP. Combined with the current account surplus, these flows led to a build-up of reserves in the region, equivalent to 3.5 per cent of GDP. The more voluminous capital flows into the region mainly reflected the large rise of foreign direct investment in the region's countries, which generated an investment flow of $95 billion, the highest foreign direct investment figure ever for Latin America and the Caribbean. This was combined with a steep fall of outward direct investment by the region's countries, as compared with the figures for 2006 (see figure XII).

40. Net foreign direct investment flows increased substantially in a number of countries. Colombia, Costa Rica, Ecuador and Mexico saw increases of more than 20 per cent and Chile, El Salvador, Guatemala and Peru of more than 50 per cent. The country that experienced the largest absolute rise was Brazil, with foreign direct investment inflows estimated at an unprecedented figure of almost $35 billion.

Figure XII
Latin America and the Caribbean: sources and uses of the balance of payments
(Millions of United States dollars)



Source: ECLAC, on the basis of official figures and the International Monetary Fund.
[a] Preliminary figures.
[b] Negative values indicates an increase in reserves.

41. During the course of 2007, foreign investors sought out financial investment opportunities in countries in the region whose domestic markets showed particular growth potential, especially those offering advantages in terms of interest rates and expected currency appreciation. The largest flows resulted from short-term operations (particularly the carry trade in Brazil and Colombia), which are better suited to contexts of volatility like that seen in the international markets during 2007. Brazil and Colombia also experienced the smallest rise in country risk (as measured by the Emerging Markets Bond Index Plus) over the year, even in the periods of greatest risk-aversion.

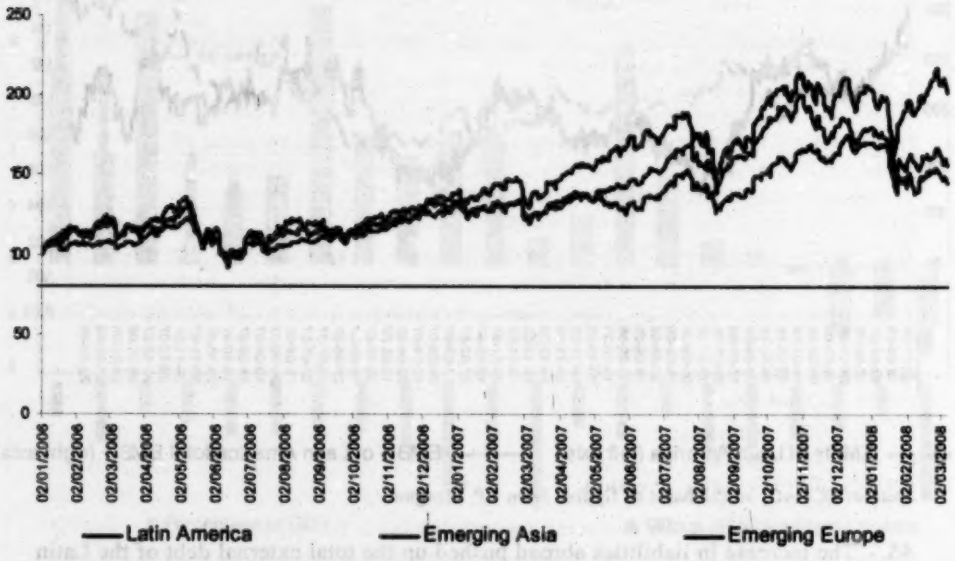
42. A breakdown of the financial account between the public and private sectors reveals some characteristics of the financial operations conducted with other countries. First, the most substantial negative financial flows were due to the build-up of assets abroad by Chile and Venezuela (Bolivarian Republic of), involving not only the public sector but also mutual and pension funds (Chile), companies (Chile, Venezuela (Bolivarian Republic of)) and individuals (Chile). The build-up of external assets by the public sector continued to be driven by fiscal, monetary and exchange-rate policy decisions. Second, the build-up of these assets was offset at the regional level by inflows of foreign portfolio investment and higher external borrowing, in particular in Brazil and Mexico. The great bulk of financial flows in the Brazilian public sector consisted of foreign investment in Brazilian securities, most of them negotiated within the country. In Mexico, public-sector financial flows were largely derived from securities issued abroad, mainly to finance initiatives under the "Projects with deferred impact in the recording of public expenditure" scheme and from an increase in foreign loans. In most of the region's other countries, financial capital inflows into the public sector came from higher foreign

borrowing, in particular in the form of short-term loans. The dynamism of capital flows to the private sector was the third major feature. The sector is estimated to have received net financial capital flows of some $17 billion across the region, which is higher than the figure for the previous year. These investments drove up share prices significantly, especially on the Brazilian, Chilean, Colombian and Peruvian stock markets. This was one factor behind the remarkable surge in the stock market indices of the Latin American countries, which outstripped share price gains in the emerging economies of Asia and Europe, according to the relevant Morgan Stanley Capital International indices (see figure XIII). Unlike what occurred in 2006, the final balance on the region's financial capital account was fairly positive in 2007, since the build-up of external assets by the pubic sector was offset by large inflows of capital, to both the public and private sectors.

Figure XIII

Morgan Stanley Capital International emerging markets index, 2006-2007

(Daily series, index value of 2 January 2006 = 100)



Source: ECLAC, on the basis of figures from Bloomberg.

43. During the first two quarters of 2007, the countries of the Latin America and the Caribbean region issued a total of $33.6 billion in new bonds abroad, an increase of 9.8 per cent over the same period in 2006, even though new issues were suspended in August because of the unfavourable conditions in the international financial markets. Much of the rise in issues abroad was due to increased issues by agents in Argentina, Jamaica and Peru and Venezuela. Sovereign issues continued to lose ground to those of other sectors, which accounted for about 75 per cent of total issues up to the third quarter. The preponderance of non-sovereign issues reveals the growth potential of firms and banks in the Latin American and Caribbean countries, which have ever larger and more diverse sources of financing at their disposal.

44. The international market turmoil in August and early September, whose underlying causes had already led to some briefer episodes of volatility in February and May, had a fairly limited impact on the region. Although Latin America's country risk, as measured by the emerging markets bond index plus published by J.P. Morgan, rose from an average of about 175 basis points in June to a peak of 281 in mid-August, contributing to a temporary lull in international issues, the financial positions of foreign investors in the region did not sustain any significant or prolonged reverses (see figure XIV). This was a characteristic of emerging markets generally.

Figure XIV
Emerging markets bond index plus for Latin America and emerging markets, 2006 and 2007

(Daily series in basis points)

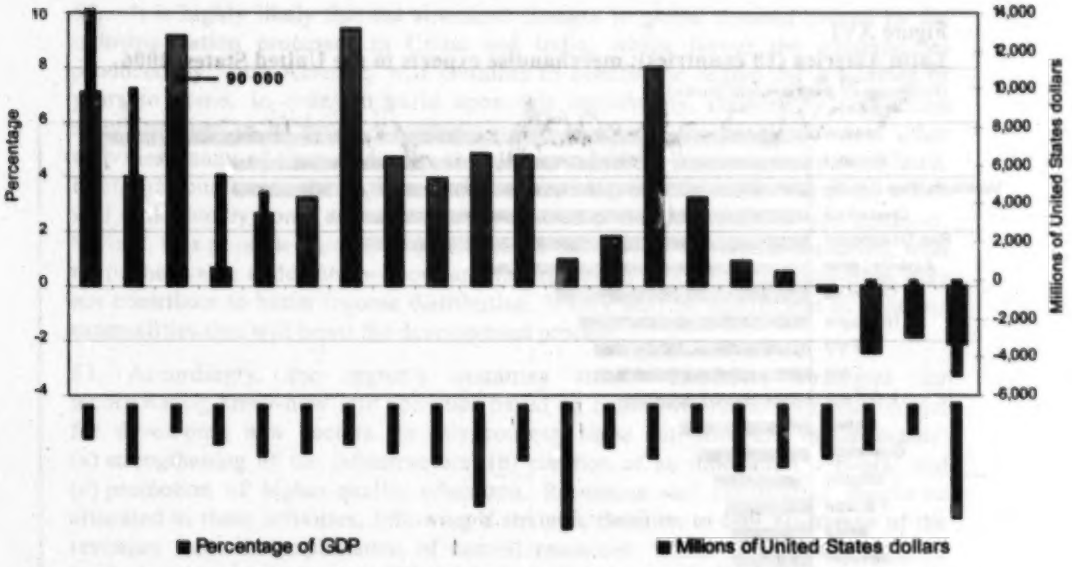
Source: ECLAC, on the basis of figures from J.P. Morgan.

45. The increase in liabilities abroad pushed up the total external debt of the Latin America and Caribbean region, in particular its short-term component. The stock of debt was some $710 billion in 2007, representing a rise of 8.7 per cent over the figure for the end of 2006, although as a percentage of GDP it is estimated to have fallen from 22 per cent to about 20.8 per cent in 2007. The rise in the stock of external debt reflected the appreciation of several of the region's currencies and other currencies, particularly the euro, against the dollar. There was also a tendency for foreign borrowing to rise in quite a number of the region's countries. The most striking exception to this rising trend was the reduction in the outstanding external debt of the region's heavily indebted poor countries (Bolivia, Guyana, Honduras and Nicaragua) as a result of debt forgiveness under the Multilateral Debt Relief Initiative, in particular by the Inter-American Development Bank.

46. As a result of operations abroad, the international reserves of Latin America and the Caribbean rose substantially in 2007 (see figure XV). This build-up

occurred in a context of currency appreciation and a rising number of monetary sterilization operations in the region. The region's international reserves totalled close to $460 billion at the end of the year, a rise of 42 per cent from the end of the previous year. The high proportion of dollar assets in the region's total international reserves creates a potential risk at a time when the value of the dollar is falling against currencies everywhere. A sharp depreciation of the dollar in the short or medium term could produce a large negative wealth effect that would be reflected in the monetary balances of central banks. This is a concern in many parts of the world, in particular in emerging countries, which hold a large proportion of the assets deriving from the external imbalance of the United States in the form of large international reserves.

Figure XV
Latin America and the Caribbean: change in international reserves, 2007[a]
(Millions of United States dollars and percentages of gross domestic product)



Source: ECLAC, on the basis of official figures and the International Monetary Fund.
[a] Preliminary figures.

V. Situation and outlook for 2008

47. Despite the turmoil in financial markets and the evolution of the United States economy, the relative stability of the region's economies provides grounds for cautious optimism. The growth trend that began five years ago is expected to continue in 2008, although at a slower pace than in 2007. The region's economic activity will expand by around 4.7 per cent, which would mean a fourth consecutive year of growth at a rate of over 3 per cent in per capita output. Domestic demand should remain strong in the region in 2008, sustained by rising investment (whose current levels, despite the increases of the past few years, are still not high enough to sustain a growth rate of approximately 5 per cent to 6 per cent). Private

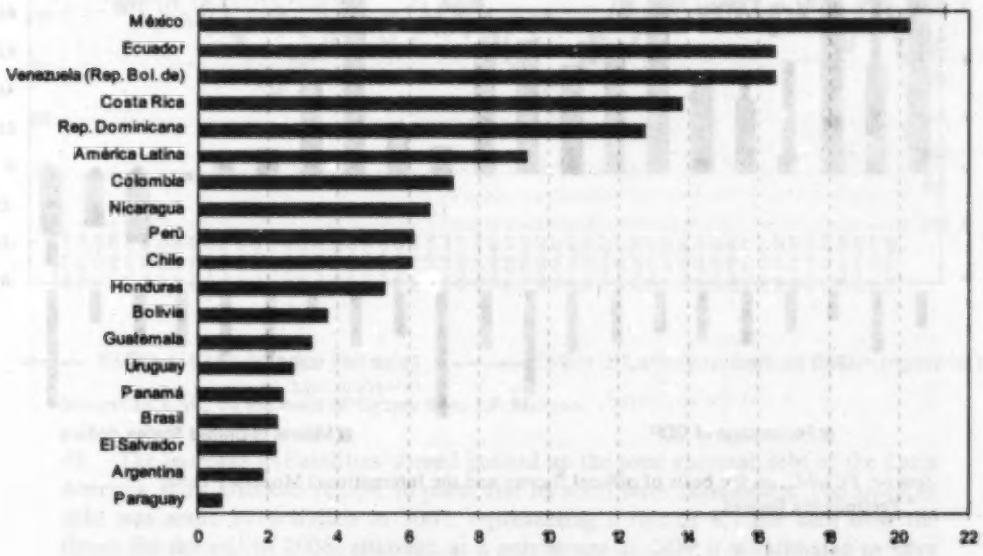
consumption, boosted by the reduction in the region's unemployment rate and the rise in formal sector employment, will also sustain domestic demand. Improved labour-market indicators and lower poverty, combined with an incipient lessening of inequity (as revealed by lower Gini coefficients in some economies), could boost consumption and thus support domestic demand in the region's countries.

48. These forecasts depend to some extent on whether the strategies implemented to control the situation in the international financial markets actually succeed in preventing a deeper retrenchment that could affect the sustainability of world growth and, in a context of greater financial market volatility, lead to mounting risk premiums and a further deterioration in financial conditions for emerging economies. The slowdown in United States growth can be expected to affect Mexico and Central America the most, as their exports are more oriented towards the United States market and consist mainly of manufactures, many of which are subject to very specific rules of origin and are thus harder to reposition in the short run (see figure XVI).

Figure XVI

Latin America (18 countries): merchandise exports to the United States, 2006

(Percentage of gross domestic product)



Source: ECLAC, on the basis of official figures.

49. Other warning signs have come from the region itself and relate to the macroeconomic policy applied in the countries, including the persistent strengthening of real exchange rates in certain South American economies, despite the measures taken by their monetary authorities. At the same time, inflation is accelerating in a number of countries, reflecting the emergence of pressures from both the supply side (rising food and energy prices) and the demand side. In addition, public spending has tended to increase everywhere, not only by more than nominal output but by more than revenues. This procyclical behaviour of public spending does not raise fiscal problems in the short term because resources have

been increasing but it does give grounds for some concern because of the possibility that it might signal a change of course in economic policy. At the same time, consumer credit is growing in several of the region's countries and this may put further upward pressure on prices at a time of steadily rising demand.

50. Central banks may face rising inflation and may need to raise interest rates at a time when international interest rates are unlikely to increase. In this context, a tighter fiscal policy seems the best strategy since it would reduce inflationary pressures as well as relieve the strain on the credit market and make it possible for interest rates to be cut.

51. Despite the performance of the region's economies in the last few years and the growth prospects for 2008, taking a longer view, there are also doubts as to whether the region is taking advantage of the favourable external situation to allocate some of the extraordinary resources available to the countries for activities that might contribute to sustained growth.

52. It is highly likely that the structural changes in global demand caused by the industrialization processes in China and India, which favour the commodities produced by Latin America, will continue to benefit the region for a number of years to come. In order to build upon this opportunity, commodity production activities need to be given a strategic boost. However, the development of other activities, many of them related to these commodities, also needs to be stimulated. First, the countries in the region should be preparing themselves for the time, which will undoubtedly come, when the relative value of the commodities will diminish. Second, it is possible that development based exclusively on natural resources, with no further value added and without any incorporation of additional know-how, may not contribute to better income distribution. It may also be insufficient to generate externalities that will boost the development process.

53. Accordingly, the region's countries should formulate strategies for incorporating know-how into activities based on natural-resources exploitation and for developing new sectors. In this context, three activities are indispensable: (a) strengthening of the infrastructure; (b) creation of an innovation network; and (c) promotion of higher-quality education. Resources and capabilities should be allocated to these activities, following a strategic decision to take advantage of the revenues from the exploitation of natural resources. While some countries have made progress in this area, it is plainly insufficient, casting doubt on the region's ability to lay the groundwork for sustainable growth.